# DOW THEORY LETTERS INC.

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40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

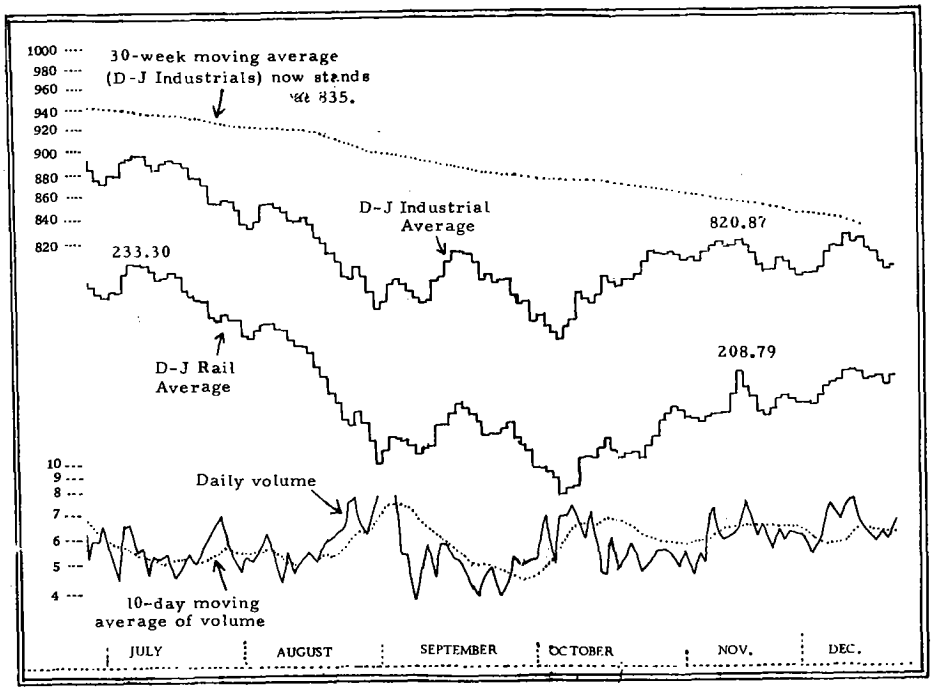

December 23, 1966 Letter 344

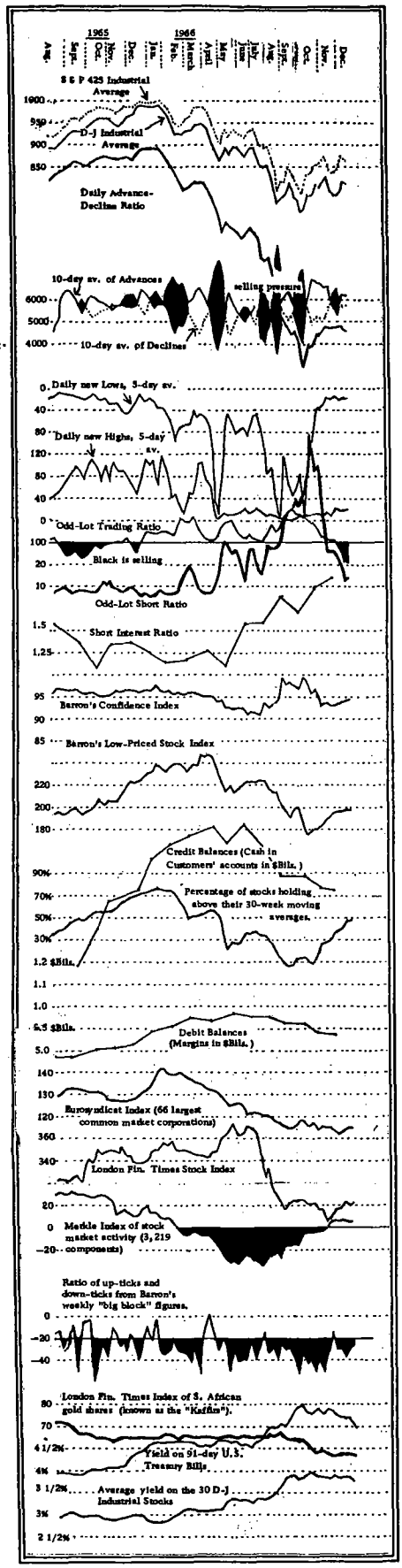
THE MARKET: In mid-November the Industrial and Rail Averages recorded recovery peaks of 820.87 and 208.79 respectively. After backing off in late-November, the Averages rallied again. On December 12 and 13, as volume boiled over into the 9 million share level, the Averages attempted to extend their November recovery highs. Although Rails closed at a new recovery peak just 3¢ above their November high, Industrials failed to confirm (Industrials fell 33¢ short of their own comparable November peak). Then amid gathering indications of a business downturn, the Averages sold off. Although nothing has yet been proved, I viewed the November-December action as rather unimpressive—perhaps even ominous.

Of further interest is the current relationship between the Industrial Average and the advance-decline ratio (see chart on page 2). Note that since August, the Industrial Average has traced a series of rising peaks (A, B, C, D) while the advance-decline ratio during the same period has recorded a series of corresponding descending peaks (A, B, C, D). This type of action was discussed in detail in Letter 342; it has, in the past, frequently been the forerunner of major trouble in the market.

For the short term the situation could not possibly be more confusing for the average investor. First the market declined during most of 1966 while the business news remained rosy. Lately, the investor has been perplexed to see the market rallying while the business news turned distinctly gloomy. What is one to think? The short interest is huge, odd-lotters are selling, the October lows are still holding in the Averages. Nevertheless, I continue to urge my readers to adopt the "big view," which is — on a long term basis, we are in a primary bear market. We are now in the second (psychological) phase, and we know from past history that the second phase is usually the most deceptive phase of a bear market. It may be towards the end of the first quarter of next year before the market clarifies its trend. By that time it is my guess that the clarification will be in the form of new lows for the Averages.

The economic contraction is beginning to assume the pattern of an international situation. West Germany is in trouble, giant Volkswagen is shutting down all production for three weeks in January, and German politicians are wondering how to get things "going again." England is in very much worse shape than Germany. England, like the U.S., is smothered





1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

in a blanket of "official propaganda," and the average worker in England has been fed a line of nonsense for so long that he can hardly tell truth from fallacy. But do not bet on government "fooling all the people all the time." In the end the British, like the Americans, are going to see what is happening. Then there is most likely to be a public explosion and a nasty one. Lastly, France is slowing down, and it is reported (UPI) that the "de Gaulle government is increasingly concerned over the sharp worsening of France's economic outlook only three month's before critical parliamentary elections."

So all of this is what the primary bear market has to weigh and measure over the period ahead. If the worst that can be foreseen has already been discounted by the Averages, then the bear market ended at the October lows. But if the bear market is to continue (and I think it will), the national and international picture is going to get very much worse, and the Averages will discount such coming conditions by smashing below their October lows. Subscribers should remember that a bear market (like a bull market) is full of surprises. Most of the surprises have to do with things becoming worse, month by month, than anyone believe probable or possible. It is not a pleasant thought, but this is the type of action that is going to produce bargains, ultimate great bargains, for readers of these Letters who take my advice and stay liquid through this bear market.

NOTES, QUOTES: Writing about the new supposedly "supra-national greenback" which is being dubbed "paper gold," famed economist Melchior Palyi had this to say (December 14): "The money-magicians may or may not agree on how to fabricate gold - the last word will be up to the respective governments. They are lined up, as one would expect. Those gaining real gold want no part of the paper-gold. It is a virtual certainty that France, Belgium, and Switzerland will either keep out of the deal altogether or participate to a nominal extent only. No more than nominal participation can be expected from Germany and the Netherlands. The heat Treasury Secretary Henry Fowler puts on the continental authorities merely serves to cool down the latter's sympathies (if any) for the dollar.

"Why is Fowler so anxious to lay the treasury's hand on some paper-gold? Evidently, he is aware of the monetary facts of life: that our foreign payments are in a chronic disorder; that our gold reserve (of the real kind), down to 13 billion dollars, has been eroded to the tune of 2.5 billion dollars in the last 21 months, while our short-term debt to foreigners keeps accumulating (by 2 billion dollars in the first nine months of 1966!); that at some point the dollar may be subjected to a world-wide run, spelling a currency debacle and financial ruin. In fact, the gold exchange standard - based as it is on the shaky assumption that the dollar is "as good as gold" - is being slowly but surely liquidated. Leading central banks are systematically reducing the percentage of dollar holdings in their reserves, as shown in the table.

"Percentage share of dollars in selected monetary reserves: (Source: I.M.F. International Financial Statistics)

| | End of 1963 | End of Sept. 1966 |
|---|---|---|
| Austria | 55 | 43 |
| Belgium | 24 | 21 |
| Canada | 69 | 55 |
| France | 29 | 11 |
| Germany | 46 | 33 |
| Netherlands | 16 | 13 |
| Spain | 48 | 29 |

"How to protect our residual 13 billion dollar gold reserve, overloaded by a 'maturing mortgage' of more than 31 billion dollars in short-term foreign claims, with continued payments deficits in store, is the question. International credit arrangements to protect the dollar are either exhausted or available only for temporary rescue operations. In any case they are totally inadequate to cope with the fundamental disequilibrium that has been brought about by our own misguided fiscal and monetary policies."

And writing on December 14, economist Eliot Janeway has some enlightening words to say about the new economic troubles of Europe: "As for Europe's famous boom, which we have been taking for granted for the better part of 20 years, it has already run out of money: and it is now running out of customers. Europe's surplus industrial products are on a collision course with the American price level.

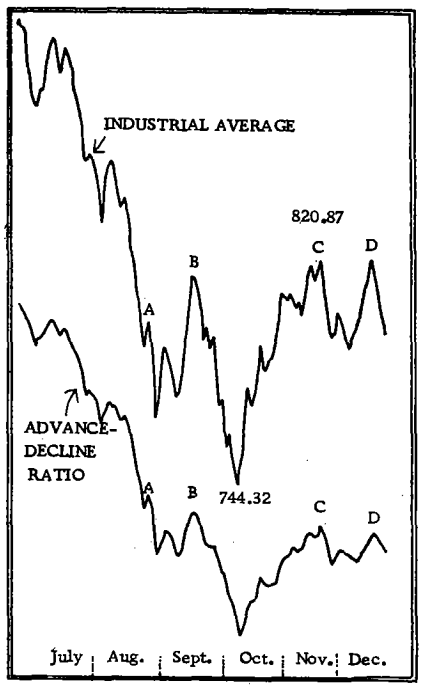
"The structure of Europe's economies, unlike our own, makes them all export-dependent. Ever since the Korean war started them into a conventional boom, they have been expanding their capacities. So long as the dollar was in easy supply around the world, they were able to expand exports too.

"But the moment smaller markets of anything anywhere in the world go bad, the bigger producers look to the American market for a bail-out. For no matter how sick any of our American markets may seem by our own standards, they remain inviting by foreign standards. This is now true of steel.

"While the most conspicuous market break of 1966 was that in the American stock market, perhaps the most prophetic for 1967 was the drop of nearly 6 per cent recorded in western Europe's exported steel tonnage. The drastic price-cutting to which Europe is being driven in order to limit her export losses makes a joke out of Wall street's recent effort to rally behind the embattled steel stocks."

BEAR MARKET THOUGHTS: In the three months since the October, 1966 lows, almost every "method," "device" and "system" on Wall Street has flashed its own brand of bull signal (except, of course, for Dow's Theory). But the fact is that following a major decline such as that of 1966, any sustained rally is bound to set off sundry and assorted "bull signals." Read almost any advisory service today, and you will note that its analysts have now turned bullish. The 8-month decline of 1966 made little impression on these analysts, but the rally since October has impressed them no end. In Wall Street as everywhere else, people believe what they want to believe.

Over and over again during the past few weeks I have heard the following: "Russell, we know it has been a bear market during most of 1966, but what would the market now have to do in order to give us a Dow Theory bull signal?" In answer, my thoughts always turn to a single fundamental example. I am standing on the beach watching the waves. As each successive wave washes in, I place a stick at the point where that wave spends itself in the sand. The sticks move further and further from the ocean. Finally, the tide reaches its extreme high, and it is obvious that the last-placed stick will not again be touched by a wave until the next period of high tide. Then I reverse the process; I start moving my sticks closer to the water as each successive wave fails to carry as far as the preceding wave.



As I move my sticks closer to the water, a young boy walks up and asks, "What will it take to bring the ocean back to high tide again?" My answer is this: "Well, an act of God such as a typhoon or a tidal wave would probably take the tide to high immediately. But in the absence of such an extraordinary act of God, the ocean is going to have to go through all its phases—all the way back to low tide—then slowly back to high tide before my farthest stick is touched again. You see, there is a matter of phase and time. Barring an act of God, it is useless to look for high tide anymore today."

The same line of reasoning can be applied to the market. I seem to belong to that Neanderthal group of Wall Streeters who believe that primary bear markets inevitably follow bull markets, and that this is so regardless of Presidential wishes, Congressional scoldings or Treasury and Federal Reserve manipulations. I realize that this type of classical or orthodox thinking is particularly difficult for today's younger generation to swallow. For to believe that a bear market must follow a bull market is to dismiss Keynesian theory and the "New Economics," it is to laugh off the economic "truths" of the last 30 years. Even more frightening, it is to admit that this nation could get "bought up" and over its head in debt (as it is today), and then get caught in an economic "bust" (as it is liable to in the period ahead). All in all, it's hardly a pleasant line of reasoning.

Therefore, I might as well confess all; I simply do not believe that our "economic scientists" have found a way to outlaw business collapses any more than they have discovered a way to eliminate booms. Further, I do not believe our planners have displaced the law of supply and demand. I do believe this, however. I think that our Washington economists have worked out methods of temporarily holding back many natural laws. And in so doing, I believe they have succeeded in building a bigger boom. The 1949-66 became a mighty monster, rather than a smaller, healthier, more solidly-based period of economic expansion. And for this reason, the 1949-66 boom is most likely to be followed by a long period of economic pain and contraction, rather than a smaller recession of the 1957 or 1960 variety.

Dow, Hamilton and Rhea believed that the bigger the bull market and the greater the period of economic excess, the greater the probable duration and extent of the ensuing bear market. I have always subscribed to this same view. It seemed too fundamental, too well-founded in past history to deny.

But to get back to the present, all bear markets are subject to three psychological phases, and these phases must take place through time. Most bear markets have lasted about a quarter to a third as long as the preceding bull market. The 1949-66 bull market lasted 17 years, and I would therefore expect the current bear market to last anywhere from 3 to 5 years. I expressed the belief that the first phase of the bear market ended around August, 1966, when the 1965 low was violated. The first phase eliminated much of the froth of the preceding bull market top. It is also my thought that we are now in the early part of the second phase of the bear market. This is usually the most deceptive and violent phase, and somewhere during the second phase I would expect to see stocks and business heading for lower levels together. For during the second phase, the market generally goes down in response to poor business and shrinking corporate profits. That's the nature of the second phase.

But what formation in the Averages, I am asked, would signal that a new bull market has started? As far as I am concerned, I would distrust any bullish formation in the Averages until after the bear market had entered its third or final phase. In fact, I believe that all the "bull signals" currently being received by so many investment services are simply deceptive minor signals, the sort of signals I would expect to appear during a bear market's deceptive second phase. The signals are bound to occur, and it is these signals which keep people happy and hoping. After all, if everyone turned bearish at once, the bear market would end in a day. And no such phenomenon has yet occurred in Wall Street annals.

Remember the "bear signals" in 1953, 1957, 1960, 1962? Each subsequently proved to be deceptive, and each was followed by new highs in the Averages. All of these signals occurred within the framework of a giant and continuing primary bull market. In my opinion, the various bull signals of the past month are all secondary upward signals, and in time they will be washed away by the overriding and continuing power of the primary bear market. I warn subscribers not to get caught up in "new bull market" thinking over the period ahead. It is the type of thinking which is apt to prove costly over the long term.

QUESTION: You keep talking about liquidity and having a fully cash (or Treasury bill) position. Why all the accent on liquidity? What's wrong about having a few stocks even if this is a primary bear market?

ANSWER: First, I don't believe in "playing games" with my money in the stock market. I believe there is such a thing as correct investment procedure. I like to think in terms of correct investment procedure because it eliminates the possibility of a lot of costly emotional nonsense.

For instance, I have found through experience and through talking to hundreds of subscribers that the general policy of holding even a few stocks during a bear market or shorting a few stocks during a bull market is almost always a losing proposition. The fact is that it pays to invest in harmony with the primary trend, and in general this means holding shares during a bull market and holding cash during a bear market (I have found that shorting, even during a primary bear market, is usually unsatisfactory for the average investor).

Sure, there is always the stock that doubles during a bear market. There is always something going against the primary trend (didn't many stocks such as U.S. Steel, Brunswick and Studebaker collapse even while the 1949-66 bull market was in effect?). But in this

 business we are constantly playing the odds, and the odds say that you are going to lose money if you invest against the primary trend of the market.

In my experience, if you hold 2/3rds cash and 1/3rd stock during a bear market, you are probably going to lose something on that 1/3rd stock, so why hold any stock at all. Why not allow the powerful primary forces to work for you? It is clear enough how primary bull forces will work for you during a bull market, but how can a primary bear market work for you? Here's how. If you hold cash (Treasury bills, a few gold shares) the purchasing power of your cash holdings are not apt to diminish during the bear market. But the price of equities, negotiable articles, paintings, coins, stamps, objets d'art, real estate, etc., is most likely to go down. This means that as the primary bear market runs nearer and nearer conclusion, the value of your fixed cash holdings are going to appreciate in terms of purchasing power. Your cash will buy more and more as the bear market asserts itself through time.

Remember this, a true primary bear market is a rarity. You may only see two or three in a lifetime. Perhaps you will only see one major bear market in your lifetime. But when a great primary bear market arrives, it can produce fortune-making opportunities simply because it is so unexpected and so few people believe it can occur and so few people are ready for it. Many feel that it is not "nice" to benefit from another man's misfortune in the market. But it is hardly a plot on your part when stocks collapse. When you buy a stock at half the price it was a year ago, you may be taking advantage of a change in prices, but you are hardly hurting anyone when you buy that stock. By the same token, those who buy stocks at the bottom of a bear market are being anything but destructive. It is true that stocks were pushed up too high through the blindness, ignorance and miscalculations of thousands of other (often greedy) investors. But the buyer at the bottom is serving a useful purpose, he is "laying his money on the line," after thousands of others have given up in disgust.

Somewhere ahead, after today's optimists and "New Economics" adherents have "thrown in the sponge," stocks will be on the bargain table. Many of today's professional "hopers" will have left Wall Street in disgust (as they always do), and the patient investors will gather the great values, perhaps blue-chip and growth stocks yielding from 5% to 10%. Yes, I've seen the optimists and New Era boys desert Wall Street even though the bargains were there. Do you want to do a little research along these lines? Then go to your city library and look up Barron's during 1942 and 1949. Peruse any issue and count the number of investment advisory advertisements. You'll be amazed at how few ads were there. Why, why was this so at a time when stocks were on the bargain counter and investment advisors, if they were bullish, should have been in a position to provide great buying advice? The reason is that few investment advisors are bullish or even in business when stocks are great values. And few people are around the Street to read them even if they are in business. That's the way Wall Street works, and don't forget it. Wall Street runs to extremes, and the fortunes are made when everybody abandons the ship. That's when the true investor is buying. It will happen again, even though not one in a thousand believes it today.

QUOTE OF THE WEEK: (Newsweek, December 26)..."The full force of LBJ's economic troubles has yet to be felt. With Federal expenditures soaring towards $140 billion, he must next month, send the biggest budget in history to Congress. Further, if he does not ask for more taxes—as he now says he must—he may 'cool' an economy that is already slowing down and risk a recession. An additional body blow—and, according to some Lyndonologists, the tip-off that LBJ indeed might not run again—was the resignation of right-hand man Bill Moyers."

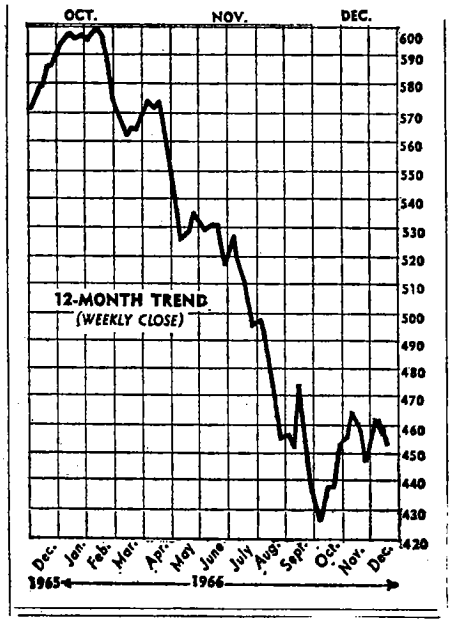



CHART OF THE WEEK: The 50-stock Average of the New York Times has, in the past, often served as a trend leader. This Average is unique in that it is made up of 25 industrial and 25 rail stocks. Since Rails (on the Dow) have held up better than Industrials since last September, it is surprising to see the outline of the Times Average. Note that the Times Average shows three descending peaks, September, November and December. This is in sharp contrast to the same peaks on the Dow, which were 814.30, 820.87 and 820.54. In other words, the Times Average has lagged the Dow by a considerable amount. In fact, the "head-and-shoulders bottom" which has, until recently, excited so many students of the Dow, does not even show on the Times chart.

TEXTILES: I have been listing major "backbone of the economy" stock groups which have topped out. Add Textiles to this list as seen from the charts of Am. Enka, Burlington, Celanese, Stevens, United Merchants, five of the textile giants. What's wrong—overproduction, overseas competition, price cuts coming next year. (Charts courtesy of Quote Digest, 110 N. Lorraine, Witchita, Kansas).